2000

Proposed statement on auditing standards : amendment to Statement on auditing standards no. 55, Consideration of internal control in a financial statement audit, as amended by Statement on auditing standards no. 78, Consideration of internal control in a financial statement audit : an amendment to Statement on auditing standards no. 55;Amendment to Statement on auditing standards no. 55, Consideration of internal control in a financial statement audit, as amended by Statement on auditing standards no. 78, Consideration of internal control in a financial

statement audit : an amendment to Statement on auditing standards no. 55

American Institute of Certified Public Accountants. Auditing Standards Board

American Institute of Certified Public Accountants. Technology Issues Task Force

EXPOSURE DRAFT

PROPOSED STATEMENT ON AUDITING STANDARDS

AMENDMENT TO STATEMENT ON AUDITING STANDARDS NO. 55, *CONSIDERATION OF INTERNAL CONTROL IN A FINANCIAL STATEMENT AUDIT*, AS AMENDED BY STATEMENT ON AUDITING STANDARDS NO. 78, *CONSIDERATION OF INTERNAL CONTROL IN A FINANCIAL STATEMENT AUDIT: AN AMENDMENT TO STATEMENT ON AUDITING STANDARDS NO. 55*

November 1, 2000

Prepared by the AICPA Auditing Standards Board for comment from persons interested in auditing and reporting issues

Comments should be received by January 1, 2001, and addressed to Jackie Walker, Audit and Attest Standards, File 4420, AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775 or via the Internet to jwalker@aicpa.org

November 1, 2000

Accompanying this letter is an exposure draft, approved by the Auditing Standards Board (ASB), of a proposed Statement on Auditing Standards (SAS) titled *Amendment to Statement on Auditing Standards No. 55,* Consideration of Internal Control in a Financial Statement Audit*, as Amended by Statement on Auditing Standards No. 78,* Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55. The proposed Statement amends SAS No. 55, as amended by SAS No. 78, to provide guidance to auditors about the effect of information technology on internal control, and on the auditor's understanding of internal control and assessment of control risk. A summary of the significant provisions of the proposed SAS accompanies this letter.

Comments or suggestions on any aspect of this exposure draft will be appreciated. To facilitate the ASB's consideration of responses, comments should refer to specific paragraphs and include supporting reasons for each suggestion or comment.

In developing guidance, the ASB considers the relationship between the cost imposed and the benefits reasonably expected to be derived from audits. It also considers the differences the auditor may encounter in the audit of financial statements of small entities and, when appropriate, makes special provisions to meet those needs. Thus, the ASB would particularly appreciate comments on those matters.

Written comments on the exposure draft will become part of the public record of the AICPA and will be available for public inspection at the offices of the AICPA after February 1, 2001, for one year. Responses should be sent to Jackie Walker, Audit and Attest Standards, File 4420, AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775 in time to be received by January 1, 2001. Responses also may be sent by electronic mail to jwalker@aicpa.org.

Sincerely,

Deborah D. Lambert
Chair
Auditing Standards Board

Arleen R. Thomas
Vice President
Professional Standards and Services

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SUMMARY

WHY ISSUED

This proposed Statement on Auditing Standards (SAS) amends SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards,* vol. 1, AU sec. 319), as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55* (AICPA, *Professional Standards,* vol. 1, AU sec. 319) to provide guidance to auditors about the effect of information technology (IT) on internal control, and on the auditor's understanding of internal control and assessment of control risk. The Auditing Standards Board (ASB) believes the guidance is needed because entities of all sizes increasingly are using IT in ways that affect their internal control and the auditor's consideration of internal control in a financial statement audit. Consequently, in some circumstances, auditors may need to perform tests of controls to perform effective audits.

WHAT IT DOES

This proposed SAS amends SAS No. 55, as amended by SAS No. 78, to—

1. Incorporate and expand on the concept from SAS No. 80, *Amendment to Statement on Auditing Standards No. 31*, Evidential Matter (AICPA, *Professional Standards*, vol. 1, AU sec. 326.14), that in circumstances where a significant amount of information supporting one or more financial statement assertions is electronically initiated, recorded, processed, and reported, the auditor may determine that it is not practical or possible to restrict detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions. In such circumstances, the auditor should obtain evidential matter about the effectiveness of both the design and operation of controls to reduce the assessed level of control risk.

2. Describe how IT may affect internal control, evidential matter, and the auditor's understanding of internal control and assessment of control risk.

3. Describe both benefits and risks of IT to internal control, and how IT affects the components of internal control, particularly the control activities and information and communication components.

4. Provide guidance to help auditors determine whether specialized skills are needed to consider the effect of computer processing on the audit, to understand the controls, or to design and perform audit procedures.

5. Clarify that in obtaining an understanding of the entity's financial reporting process, the auditor should understand how both standard, recurring entries and nonstandard, nonrecurring entries are initiated and recorded, and the auditor should also understand the controls that have been placed in operation to ensure that such entries are authorized, complete, and correctly recorded.

6. Update terminology and references to IT systems and controls.

The proposed SAS does not—

1. Eliminate the alternative of assessing control risk at the maximum level and performing a substantive audit, if that is an effective approach.

2. Change the requirement to perform substantive tests for significant account balances and transaction classes.

HOW IT AFFECTS EXISTING STANDARDS

This proposed SAS amends SAS No. 55, as amended by SAS No. 78.

PROPOSED STATEMENT ON AUDITING STANDARDS

AMENDMENT TO STATEMENT ON AUDITING STANDARDS NO. 55, *CONSIDERATION OF INTERNAL CONTROL IN A FINANCIAL STATEMENT AUDIT,* AS AMENDED BY STATEMENT ON AUDITING STANDARDS NO. 78, *CONSIDERATION OF INTERNAL CONTROL IN A FINANCIAL STATEMENT AUDIT: AN AMENDMENT TO STATEMENT ON AUDITING STANDARDS NO. 55**

~~INTRODUCTION~~

1. This Statement provides guidance on the independent auditor's consideration of an entity's internal control in an audit of financial statements in accordance with generally accepted auditing standards. It defines internal control,[1] describes the objectives and components of internal control, and explains how an auditor should consider internal control in planning and performing an audit. In particular, this section provides guidance about implementing the second standard of field work[2]: "A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed."

SUMMARY

2. In all audits, the auditor should obtain an understanding of internal control sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements, and whether they have been placed in operation. ***In obtaining this understanding, the auditor considers how an entity's use of information technology (IT), manual procedures, and other processes may affect controls relevant to the audit. The auditor then assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements.***

3. The auditor may determine that performing tests of controls to assess control risk below the maximum for certain assertions would be effective and more efficient than performing only substantive tests. In addition, the auditor may determine that it is not practical or possible to restrict detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions. In such circumstances, the auditor should obtain evidential matter about the effectiveness of both the design and operation of controls to reduce the assessed level of control risk. Such evidential matter may be obtained from tests of controls planned and performed concurrently with obtaining the understanding, or from procedures that were not specifically planned as tests of controls but that nevertheless provide evidential matter about the design and operation of the controls.

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* New language is shown in boldface italics; deleted language is shown in strikethrough.

[1] Internal control *also may be referred to as internal control structure.*

~~[2] This section revises the second standard of fieldwork of the ten generally accepted auditing standards.~~

4. After obtaining the understanding and assessing control risk, the auditor may desire to seek a further reduction in the assessed level of control risk for certain assertions. In such cases, the auditor considers whether evidential matter sufficient to support a further reduction is likely to be available and whether performing additional tests of controls to obtain such evidential matter would be efficient.

~~5.3. After obtaining this understanding, the auditor assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements.~~ ***Alternatively, t***~~T~~he auditor may assess control risk at the maximum level (the greatest probability that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by an entity's internal control) because he or she believes controls are unlikely to pertain to an assertion~~,~~ ***or*** are unlikely to be effective, or because evaluating the~~ir~~ effectiveness ***of controls*** would be inefficient. ***However, the auditor needs to be satisfied that performing substantive tests alone would be effective in restricting detection risk to an acceptable level.*** ~~Alternatively, the auditor may obtain evidential matter about the effectiveness of both the design and operation of a control that supports a lower assessed level of control risk. Such evidential matter may be obtained from tests of controls planned or performed concurrently with obtaining the understanding or from procedures performed to obtain the understanding that were not specifically planned as tests of controls.~~

~~4. After obtaining the understanding and assessing control risk, the auditor may desire to seek a further reduction in the assessed level of control risk for certain assertions. In such cases, the auditor considers whether evidential matter sufficient to support a further reduction is likely to be available and whether performing additional tests of controls to obtain such evidential matter would be efficient.~~

6.5.. The auditor uses the knowledge provided by the understanding of internal control and the assessed level of control risk in determining the nature, timing, and extent of substantive tests for financial statement assertions.

DEFINITION OF INTERNAL CONTROL

7.6. *Internal control* is a process—~~e~~effected by an entity's board of directors, management, and other personnel—designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (*a*) reliability of financial reporting, (*b*) effectiveness and efficiency of operations, and (*c*) compliance with applicable laws and regulations.

8.7. Internal control consists of five interrelated components, which are:

a. *Control environment* sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.

b. *Risk assessment* is the entity's identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed.

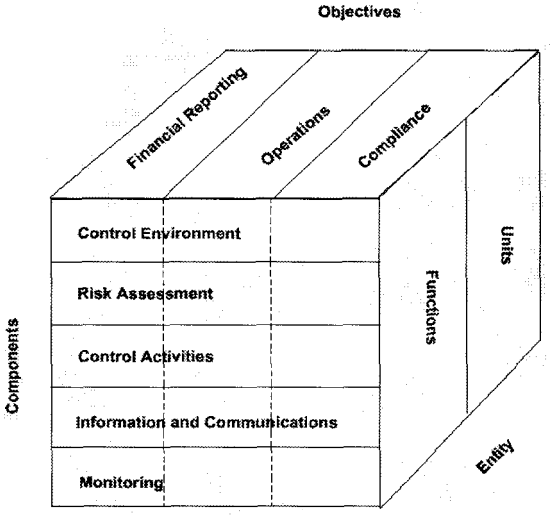
c. *Control activities* are the policies and procedures that help ensure that management directives are carried out.

d. *Information and communication* are the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.

e. *Monitoring* is a process that assesses the quality of internal control performance over time.

RELATIONSHIP BETWEEN OBJECTIVES AND COMPONENTS

9.~~8.~~ There is a direct relationship between objectives, which are what an entity strives to achieve, and components, which represent what is needed to achieve the objectives. In addition, internal control is relevant to the entire entity, or to any of its operating units or business functions. This relationship is depicted as follows:



10.~~9.~~ Although an entity's internal control addresses objectives in each of the categories referred to in paragraph *7* ~~6~~, not all of these objectives and related controls are relevant to an audit of the entity's financial statements. Also, although internal control is relevant to the entire entity or to any of its operating units or business functions, an understanding of internal control relevant to each of the entity's operating units and business functions may not be necessary ***to plan and perform an effective audit.***

Financial Reporting Objective

11.~~10.~~ Generally, controls that are relevant to an audit pertain to the entity's objective of preparing financial statements for external purposes that are fairly presented in conformity with generally accepted accounting principles or a comprehensive basis of accounting other than generally accepted accounting principles.[2 3]

Operations and Compliance Objectives

12.~~11.~~ The controls relating to operations and compliance[3 4] objectives may be relevant to an audit if they pertain to data the auditor evaluates or uses in applying auditing procedures. For example, controls pertaining to nonfinancial data that the auditor uses in analytical procedures, such as production

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[2 3] The term *comprehensive basis of accounting other than generally accepted accounting principles* is defined in Statement on Auditing Standards (SAS) No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623.04). Hereafter, reference to generally accepted accounting principles in this section includes, where applicable, an other comprehensive basis of accounting.

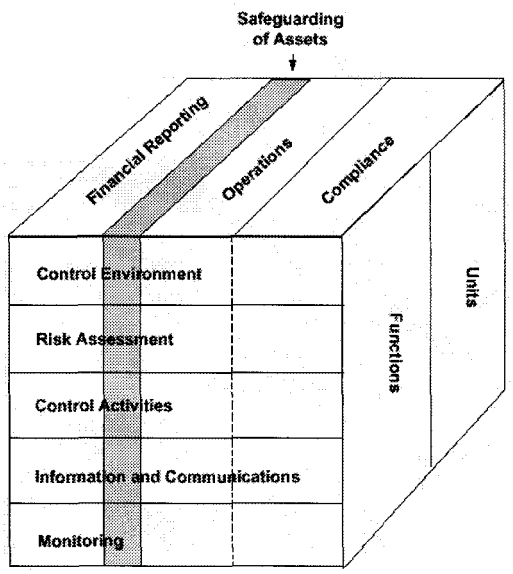
[3 4] An auditor may need to consider controls relevant to compliance objectives when performing an audit in accordance with SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801).

statistics, or pertaining to detecting noncompliance with laws and regulations that may have a direct and material effect on the financial statements, such as controls over compliance with income tax laws and regulations used to determine the income tax provision, may be relevant to an audit.

13. ~~12.~~ An entity generally has controls relating to objectives that are not relevant to an audit and therefore need not be considered. For example, controls concerning compliance with health and safety regulations or concerning the effectiveness and efficiency of certain management decision-making processes (such as the appropriate price to charge for its products or whether to make expenditures for certain research and development or advertising activities), although important to the entity, ordinarily do not relate to a financial statement audit. ***Similarly, commercial airlines may rely on a sophisticated system of automated controls to maintain flight schedules, but these controls would not be relevant to the financial statement audit and therefore need not be considered.***

Safeguarding of Assets

14. ~~13.~~ Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to financial reporting and operations objectives. This relationship is depicted as follows:



In obtaining an understanding of each of the components of internal control to plan the audit, the auditor's consideration of safeguarding controls is generally limited to those relevant to the reliability of financial reporting. For example, use of a lockbox system for collecting cash or ***computer access controls (for example,*** passwords***) that*** ~~for limiting~~ access to ***the data and programs that process cash disbursements*** ~~accounts receivable data files~~ may be relevant to a financial statement audit. Conversely, controls to prevent the excess use of materials in production generally are not relevant to a financial statement audit.

APPLICATION OF COMPONENTS TO A FINANCIAL STATEMENT AUDIT

15. ~~14.~~ The division of internal control into five components provides a useful framework for auditors to consider the impact of an entity's internal control in an audit. However, it does not necessarily reflect how an entity considers and implements internal control. Also, the auditor's primary consideration is whether a specific control affects financial statement assertions rather than its classification into any particular component. ***Controls relevant to the audit are those that individually or in combination with others***

are likely to prevent or detect material misstatements in financial statement assertions. Such controls may exist in any of the five components.

16. ~~15.~~ The five components of internal control are applicable to the audit of every entity. The components should be considered in the context of—

- The entity's size.
- The entity's organization and ownership characteristics.
- The nature of the entity's business.
- The diversity and complexity of the entity's operations.
- ***Applicable legal and regulatory requirements.***
- The ***nature and complexity of the systems that support the*** entity's ***internal control, including the use of services of other organizations.***[4] ~~methods of transmitting, processing, maintaining, and accessing information.~~
- ~~Applicable legal and regulatory requirements.~~

EFFECTS OF IT ON INTERNAL CONTROL

17. An entity's use of IT may affect any of the five components of internal control relevant to the achievement of the entity's financial reporting, operations, or compliance objectives, and its operating units or business functions. For example, an entity may use IT as part of discrete systems that support only particular business units, functions, or activities, such as a unique accounts receivable system for a particular business unit or a system that controls the operation of factory equipment. Alternatively, an entity may have complex, highly integrated IT systems that share data and that are used to support all aspects of the entity's financial reporting, operations, and compliance objectives.

18. The development of IT changed the fundamental manner in which transactions are initiated, recorded, processed, and reported from paper-based systems that rely primarily on manual controls to electronic systems using a combination of manual and automated controls. In a manual system, an entity uses manual procedures and records in paper format (for example, to enter sales orders, authorize credit, prepare shipping reports and invoices, and maintain accounts receivable records). Controls in such a system also are manual, and may include such procedures as approvals and reviews of activities, and reconciliations and follow-up of reconciling items. Alternatively, an entity may have complex IT systems that use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format replace such paper documents as purchase orders, invoices, and shipping documents. Controls in systems that use IT consist of a combination of automated controls (for example, controls embedded in computer programs), and manual controls. Further, manual controls may be independent of the IT system, may use information produced by the IT system, or may be limited to monitoring the effective functioning of the system and the automated controls, and to handling exceptions. An entity's mix of manual and automated controls varies with the nature and complexity of the entity's use of IT.

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[4] ***See SAS No. 70,*** Service Organizations (AICPA, ***Professional Standards,*** vol. 1, AU sec. 324)***, for guidance if an entity obtains services that are part of its information system from another organization.***

19. IT provides benefits of effectiveness and efficiency for an entity's internal control because it enables an entity to—

- *Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data.*
- *Enhance the timeliness, availability, and accuracy of information.*
- *Facilitate the additional analysis of information.*
- *Enhance the ability to monitor the performance of the entity's activities and its policies and procedures.*
- *Reduce the risk that controls will be circumvented, especially if controls over changes to the IT system are effective.*

20. IT systems also pose specific risks to an entity's internal control, including—

- *Overreliance on information produced by IT systems that are incorrectly processing data or consistently processing inaccurate data.*
- *Unauthorized access to data that may result in destruction of data or improper changes to data including the recording of unauthorized or nonexistent transactions or inaccurate recording of transactions.*
- *Unauthorized changes to computer programs.*
- *Failure to make necessary changes to computer programs.*
- *Inappropriate manual intervention.*
- *Potential loss of data.*

21. The extent and nature of these risks to internal control vary depending on the nature and characteristics of the entity's system. For example, when multiple users, either external or internal, access a common database of information that affects financial reporting, a lack of control at a single user entry point might compromise the security of the entire database, potentially resulting in improper changes to or destruction of data. In systems where IT personnel can make unauthorized, untested, or unapproved changes to computer programs, there is an increased risk that changes to programs could result in incorrect processing that affects financial statement assertions. Therefore, the nature and characteristics of an entity's IT system affect the entity's internal control.

LIMITATIONS OF AN ENTITY'S INTERNAL CONTROL

22.~~16.~~ Internal control, no matter how well designed and operated, can provide only reasonable assurance to management and the board of directors regarding achievement of an entity's control objectives. The likelihood of achievement is affected by limitations inherent to internal control. These include the realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of such human failures as simple error or mistake. ***Similarly, in IT systems, errors may occur in designing, maintaining, or monitoring automated controls. For example, an entity's IT personnel may not completely understand how an IT system processes sales transactions, resulting in erroneously designing required changes to the system to process***

sales for a new line of products, or such changes may be correctly designed but misunderstood by individuals who translate the design into program code. Errors may also occur in the use of information produced by IT. For example, IT systems may be designed to report transactions over a specified dollar limit for management review, but individuals responsible for conducting the review may not understand the purpose of such reports and, accordingly, may fail to review them or investigate unusual items.

23. Additionally, controls***, whether manual or automated,*** can be circumvented by the collusion of two or more people or ***inappropriate*** management override of internal control. ***For example, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contract in ways that would preclude revenue recognition. Also, management may be able to override or disable the edit routines in a software program that are designed to identify and report transactions that exceed specified credit limits.***

24.~~17.~~ Another limiting factor is that the cost of an entity's internal control should not exceed the benefits that are expected to be derived. Although the cost-benefit relationship is a primary criterion that should be considered in designing internal control, the precise measurement of costs and benefits usually is not possible. Accordingly, management makes both quantitative and qualitative estimates and judgments in evaluating the cost-benefit relationship.

25.~~18.~~ Custom, culture, and the corporate governance system may inhibit ~~irregularities by~~ management ***fraud***, but they are not absolute deterrents. An effective control environment, too, may help mitigate the probability of ***fraud***~~such irregularities~~. For example, an effective board of directors, audit committee, and internal audit function may constrain improper conduct by management. Alternatively, the control environment may reduce the effectiveness of other components. For example, when the presence of management incentives creates an environment that ***increases the risk of*** ~~could result in~~ material misstatement of financial statements, the effectiveness of control activities may be reduced. The effectiveness of an entity's internal control might also be adversely affected by such factors as a change in ownership or control, changes in management or other personnel, or developments in the entity's market or industry.

CONSIDERATION OF INTERNAL CONTROL IN PLANNING AN AUDIT

26.~~19.~~ In all audits, the auditor should obtain an understanding of each of the five components of internal control sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements, and whether they have been placed in operation. In planning the audit, such knowledge should be used to—

- Identify types of potential misstatement.
- Consider factors that affect the risk of material misstatement.
- ***When applicable, design tests of controls. Paragraphs 65 through 70 of this Statement discuss factors the auditor considers in determining whether to perform tests of controls.***
- Design substantive tests.

27.~~20.~~ The nature, timing, and extent of procedures the auditor chooses to perform to obtain the understanding will vary depending on the size and complexity of the entity, previous experience with the entity, the nature of the specific controls involved ***including the complexity of the entity's use of IT, the nature and extent of changes in systems and operations,*** and the nature of the entity's documentation of specific controls. For example, the understanding of risk assessment needed to plan an audit for an entity operating in a relatively stable environment may be limited. Also, the understanding of monitoring needed to plan an audit for a small, noncomplex entity may be limited. ***Similarly, the***

auditor may need only a limited understanding of control activities to plan an audit for a noncomplex entity that has significant owner-manager approval and review of transactions and accounting records. On the other hand, the auditor may need a greater understanding of control activities to plan an audit for an entity that has a large volume of revenue transactions and that relies on sophisticated IT systems to measure and bill for services based on a complex, frequently changing rate structure.

28. ~~21.~~ Whether a control has been *placed in operation* ***at a point in time*** is different from its *operating effectiveness* ***over a period of time***. In obtaining knowledge about whether controls have been placed in operation, the auditor determines that the entity is using them. Operating effectiveness, on the other hand, is concerned with how the control was applied, the consistency with which ***a control, whether manual or automated,*** ~~it~~ was applied, and by whom it was applied. ~~For example, a budgetary reporting system may provide adequate reports, but the reports may not be analyzed and acted on. This section does not require~~ ***T***~~t~~he auditor ***is not required*** to obtain knowledge about operating effectiveness as part of the understanding of internal control ***necessary to plan the audit***.

29. ~~22.~~ The auditor's understanding of internal control may sometimes raise doubts about the auditability of an entity's financial statements. Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted. Concerns about the nature and extent of an entity's records may cause the auditor to conclude that it is unlikely that sufficient competent evidential matter will be available to support an opinion on the financial statements.

Understanding *of* Internal Control *Necessary to Plan the Audit*

30. ~~23.~~ In making a judgment about the understanding of internal control necessary to plan the audit, the auditor considers the knowledge obtained from other sources about the types of misstatement that could occur, the risk that such misstatements may occur, and the factors that influence the design of ***tests of controls, when applicable, and*** substantive tests. Other sources of such knowledge include ***information from*** previous audits and the ***auditor's*** understanding of the industry in which the entity operates. The auditor also considers his or her assessment of inherent risk, judgments about materiality, and the complexity and sophistication of the entity's operations and systems, including ~~whether~~ the ***extent to which the entity relies on*** ~~method of controlling information processing is based on~~ manual ***controls*** ~~procedures~~ independent of the computer or ~~is highly dependent on~~ ***automated*** ~~computerized~~ controls. ~~As an entity's operations and systems become more complex and sophisticated, it may be necessary to devote more attention to internal control components to obtain the understanding of them that is necessary to design effective substantive tests.~~

31. This consideration also includes IT risks that could result in misstatements, and whether the entity has designed and placed in operation controls to prevent or detect such misstatements. For example, if an entity uses IT to perform complex calculations, the entity receives the benefit of having the correct calculations consistently performed. However, the use of IT also presents risks, such as the risk that incorrect changes (for example, changes that are not properly authorized, incorrectly defined, or improperly made) to the programs performing the calculations could result in consistently performing those calculations incorrectly. In such cases, the auditor considers whether controls that prevent or detect incorrect changes to computer programs performing the calculations have been designed and placed in operation. As an entity's operations and systems become more complex and sophisticated, it becomes more likely that the auditor would need to increase his or her understanding of the internal control components to obtain the understanding necessary to design effective tests of controls, when applicable, and substantive tests.

32. The auditor should consider whether specialized skills are needed to determine the effect of computer processing on the audit, to understand the controls, or to design and perform audit

procedures. In determining whether an IT specialist is needed on the audit team, the auditor considers factors such as the following:

- ***The complexity of the entity's systems and automated controls and the manner in which they are used in conducting the entity's business***
- ***The significance of changes made to existing systems, or the implementation of new systems***
- ***The extent to which data is shared among systems***
- ***The extent of the entity's participation in electronic commerce***
- ***The entity's use of emerging technologies***
- ***The significance of audit evidence that is available only in electronic form***

33. Procedures that an IT specialist might perform include inquiring of an entity's IT personnel how data and transactions flow through the system and are recorded, inspecting systems documentation, observing the operation of controls (e.g., controls over access to programs and data files), and planning and performing tests of controls. If the use of an IT specialist is planned, the auditor should have sufficient IT skills to communicate the audit objectives to the specialist, to evaluate whether the specialist's procedures will meet the objectives, and to evaluate the results of the procedures as they relate to the nature, timing, and extent of other planned audit procedures.[5]

34.~~24.~~ Paragraphs ***35*** ~~25~~ through ***58*** ~~40~~ provide an overview of the five internal control components and the auditor's understanding of the components relating to a financial statement audit. A more detailed discussion of these components is provided in appendix A [paragraph ***111***~~84~~].

Control Environment

35.~~25.~~ The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the following:

a. Integrity and ethical values

b. Commitment to competence

c. Board of directors or audit committee participation

d. Management's philosophy and operating style

e. Organizational structure

f. Assignment of authority and responsibility

g. Human resource policies and practices

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[5] ***See SAS No. 22,*** **Planning and Supervision (AICPA, *Professional Standards,* vol. 1, AU sec. 311.10).**

36.~~26.~~ The auditor should obtain sufficient knowledge of the control environment to understand management's and the board of directors' attitude, awareness, and actions concerning the control environment, considering both the substance of controls and their collective effect. The auditor should concentrate on the substance of controls rather than their form, because controls may be established but not acted upon. For example, management may establish a formal code of conduct but act in a manner that condones violations of that code.

37.~~27.~~ When obtaining an understanding of the control environment, the auditor considers the collective effect on the control environment of strengths and weaknesses in various control environment factors. Management's strengths and weaknesses may have a pervasive effect on internal control. For example, owner-manager controls may mitigate a lack of segregation of duties in a small business, or an active and independent board of directors may influence the philosophy and operating style of senior management in larger entities. ***Alternatively, management's failure to commit sufficient resources to address security risks presented by IT systems may adversely affect internal control by allowing improper changes to be made to computer programs or to data. Similarly,*** ~~However,~~ human resource policies and practices directed toward hiring competent financial***,*** ~~and~~ accounting***, and IT*** personnel may not mitigate a strong bias by top management to overstate earnings.

Risk Assessment

38.~~28.~~ An entity's risk assessment for financial reporting purposes is its identification, analysis, and management of risks relevant to the preparation of financial statements that are fairly presented in conformity with generally accepted accounting principles. For example, risk assessment may address how the entity considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements. Risks relevant to reliable financial reporting also relate to specific events or transactions.

39.~~29.~~ Risks relevant to financial reporting include external and internal events and circumstances that may occur and adversely affect an entity's ability to ***initiate,*** record, process, ~~summarize,~~ and report financial data consistent with the assertions of management in the financial statements.[~~6~~ 5] Risks can arise or change due to circumstances such as the following:

- Changes in operating environment
- New personnel
- New or revamped information systems
- Rapid growth
- New technology
- New ***business models,*** ~~lines,~~ products, or activities
- Corporate restructurings
- ***Expanded f***~~F~~oreign operations
- ***New a***Accounting pronouncements

[~~6~~ 5] These assertions are discussed in SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards,* vol. 1, AU sec. 326).

40.~~30.~~ The auditor should obtain sufficient knowledge of the entity's risk assessment process to understand how management considers risks relevant to financial reporting objectives and decides about actions to address those risks. This knowledge might include understanding how management identifies risks, estimates the significance of the risks, assesses the likelihood of their occurrence, and relates them to financial reporting. ***The use of IT may be an important element in an entity's risk assessment process, including the identification and management of risks relevant to financial reporting such as those in certain financial instrument transactions.***

41.~~31.~~ An entity's risk assessment differs from the auditor's consideration of audit risk in a financial statement audit. The purpose of an entity's risk assessment is to identify, analyze, and manage risks that affect entity objectives. In a financial statement audit, the auditor assesses inherent and control risks to evaluate the likelihood that material misstatements could occur in the financial statements.

Control Activities

42.~~32.~~ Control activities are the policies and procedures that help ensure that management directives are carried out. They help ensure that necessary actions are taken to address risks to achievement of the entity's objectives. Control activities***, whether automated or manual,*** have various objectives and are applied at various organizational and functional levels. Generally, control activities that may be relevant to an audit may be categorized as policies and procedures that pertain to the following:

- Performance reviews
- Information processing
- Physical controls
- Segregation of duties

43.~~33.~~ The auditor should obtain an understanding of those control activities relevant to planning the audit. As the auditor obtains an understanding of the other components he or she is also likely to obtain knowledge about some control activities. For example, in obtaining an understanding of the documents, records, and processing steps in the financial reporting information system that pertain to cash, the auditor is likely to become aware of whether bank accounts are reconciled. The auditor should consider the knowledge about the presence or absence of control activities obtained from the understanding of the other components in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities to plan the audit. Ordinarily, audit planning does not require an understanding of the control activities related to each account balance, transaction class, and disclosure component in the financial statements or to every assertion relevant to them.

44. Depending on the extent of an entity's use of IT, the auditor may need to obtain an understanding of how IT affects control activities that are relevant to planning the audit. Some entities and auditors may view the information systems control activities in terms of general controls and application controls. General controls are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of IT systems. General controls commonly include controls over data center and network operations, system software acquisition and maintenance, access security, and application system development and maintenance. The continued effective functioning of application controls depends on general controls. Application controls apply to the processing of individual applications. These controls help ensure that transactions are valid, properly authorized, and completely and accurately recorded and processed. Examples include edit checks of input data, numerical sequence checks, and manual follow-up of exception reports.

45. Application controls may be performed by IT (for example, automated reconciliation of subsystems) or by individuals. When application controls are performed by users of an IT system, they may be referred to as user controls. The effectiveness of user controls, such as reviews of computer-produced exception reports or other information produced by an IT system, may depend on the accuracy of the information produced by the system. For example, a user may review an exception report to identify credit sales over a customer's authorized credit limit, but without performing procedures to verify its accuracy. In such cases, the effectiveness of the user control (that is, the review of the exception report) depends on both the effectiveness of the user review and the accuracy of the IT processing that produces the report.

Information and Communication

46. ~~34.~~ The information system relevant to financial reporting objectives, which includes the accounting system, consists of the ***procedures*** ~~methods~~***, whether automated or manual,*** and records established to ***initiate,*** record, process, ~~summarize,~~ and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity. The quality of system-generated information affects management's ability to make appropriate decisions in controlling the entity's activities and to prepare reliable financial reports.

47. ~~35.~~ Communication involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting.

48. ~~36.~~ The auditor should obtain sufficient knowledge of the information system[7] relevant to financial reporting to understand—

- The classes of transactions in the entity's operations that are significant to the financial statements~~,~~ ***and the nature of other events and conditions that may require recognition or disclosure.***
- ***The procedures, both automated and manual, by which*** ~~How those~~ transactions are initiated, ***recorded, processed, and reported from their occurrence to their inclusion in the financial statements.***
- The ***related*** accounting records, ***whether electronic or manual,*** supporting information, and specific accounts in the financial statements involved in ~~the~~ ***initiating, recording,*** processing and reporting ~~of~~ transactions.
- ***How the system captures other events and conditions that may require recognition or disclosure.***
- ~~The accounting processing involved from the initiation of a transaction to its inclusion in the financial statements, including electronic means (such as computers and electronic data interchange) used to transmit, process, maintain, and access information.~~
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.

49. When IT is used to initiate, record, process, and report transactions for inclusion in financial statements, the IT application systems and programs may include controls related to the corresponding assertions for significant accounts, or may be critical to the effective functioning of manual controls that depend on the IT processing and electronic information.

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[7] ***See SAS No. 70 for guidance if an entity obtains services that are part of its information system from another organization.***

50. In obtaining an understanding of the financial reporting process, the auditor considers the various procedures an entity uses to produce financial reports and how misstatements may occur. For example, some IT systems automatically pass information, including transaction totals, from transaction processing systems to general ledger or financial reporting systems. The automated processes and controls in such systems reduce the risk of inadvertent error, but do not overcome the risk that individuals may inappropriately override such automated processes, for example, by changing the amounts being automatically passed to the general ledger or financial reporting system. Furthermore, there may be less visible evidence, or no evidence at all, of such intervention in IT systems.

51. Also, the financial reporting process for most entities will require management to record nonrecurring or nonstandard entries for unusual transactions or for accounting estimates. In manual, paper-based general ledger systems, such nonstandard entries (as well as the recurring standard closing entries) may be identified through inspection of ledgers, journals, and supporting documentation. However, when IT is used to maintain the general ledger and produce financial reports, such entries may exist only in electronic form and may be more difficult to identify through physical inspection of printed documents. The auditor should understand how both standard, recurring entries and nonstandard, nonrecurring entries are initiated and recorded, and the controls that have been placed in operation to ensure that such entries are authorized, complete, and correctly recorded.

52. ~~In addition, t~~***T***he auditor ***also*** should obtain sufficient knowledge of the means the entity uses to communicate financial reporting roles and responsibilities and significant matters relating to financial reporting.

Monitoring

53.~~37.~~ An important management responsibility is to establish and maintain internal control. Management monitors controls to consider whether they are operating as intended and that they are modified as appropriate for changes in conditions.

54.~~38.~~ Monitoring is a process that assesses the quality of internal control performance over time. It involves assessing the design and operation of controls on a timely basis and taking necessary corrective actions. This process is accomplished through ongoing activities, separate evaluations or by various combinations of the two. In many entities, internal auditors or personnel performing similar functions contribute to the monitoring of an entity's activities. Monitoring activities may include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.

55.~~39.~~ The auditor should obtain sufficient knowledge of the major types of activities the entity uses to monitor internal control over financial reporting, including how those activities are used to initiate corrective actions. When obtaining an understanding of the internal audit function, the auditor should follow the guidance in SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards,* vol. 1, AU sec. 322.04–.08).

56. The auditor also considers the source of the information the entity uses to monitor internal control over financial reporting. In many entities, much of the information used in monitoring is produced by IT systems. Management may rely on automated controls to ensure that computer-generated data are correct and may not perform procedures to confirm the data's accuracy. In such a case, errors may exist in the information leading management to incorrect conclusions from its monitoring activities. The auditor considers the reliability of information used to monitor internal control, regardless of whether such information is produced manually or from an IT system.

Application to Small and Midsized Entities

57.~~40.~~ As indicated in paragraph ***16*** ~~15~~, the way internal control components apply will vary based on an entity's size and complexity, among other considerations. Specifically, small and midsized entities may use less formal means to ensure that internal control objectives are achieved. For example, smaller entities with active management involvement in the financial reporting process may not have extensive descriptions of accounting procedures, sophisticated information systems, or written policies. Smaller entities may not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Similarly, smaller entities may not have an independent or outside member on their board of directors. However, these conditions may not affect the auditor's assessment of control risk.

58. When small or midsized entities are involved in complex transactions or are subject to legal and regulatory requirements also found in larger entities, more formal means of ensuring that internal control objectives are achieved may be present. ***Also, small and midsized entities may use IT in various ways to achieve their objectives. The impact of IT on an entity's internal control is related more to the nature and complexity of the systems in use than to the entity's size. For example, small entities that use the Internet or sophisticated IT systems to conduct business may have internal control that is heavily dependent on IT.***

Procedures to Obtain Understanding

59.~~41.~~ In obtaining an understanding of controls that are relevant to audit planning, the auditor should perform procedures to provide sufficient knowledge of the design of the relevant controls pertaining to each of the five internal control components and whether they have been placed in operation. This knowledge is ordinarily obtained through previous experience with the entity and procedures such as inquiries of appropriate management, supervisory, and staff personnel; inspection of entity documents and records; and observation of entity activities and operations. The nature and extent of the procedures performed generally vary from entity to entity and are influenced by the size and complexity of the entity, the auditor's previous experience with the entity, the nature of the particular control, and the nature of the entity's documentation of specific controls.

60.~~42.~~ For example, the auditor's prior experience with the entity may provide an understanding of its classes of transactions. Inquiries of appropriate entity personnel and inspection of documents and records, such as source documents, journals, and ledgers, may provide an understanding of the accounting records designed to process those transactions and whether they have been placed in operation. Similarly, in obtaining an understanding of the design of ***automated*** ~~computer-programmed~~ control***s*** ~~activities~~ and whether they have been placed in operation, the auditor may make inquiries of appropriate entity personnel and inspect relevant systems documentation, ***reports (for example, exception reports or reports evidencing the processing of transactions or application of other control activities), or other documents***~~to understand control activity design and may inspect exception reports generated as a result of such control activities to determine that they have been placed in operation~~.

61.~~43.~~ The auditor's assessments of inherent risk and judgments about materiality for various account balances and transaction classes also affect the nature and extent of the procedures performed to obtain the understanding. For example, the auditor may conclude that planning the audit of the prepaid insurance account does not require specific procedures to be included in obtaining the understanding of internal control.

Document*ing the* ~~ation of~~ Understanding

62.~~44.~~ The auditor should document the understanding of the entity's internal control components obtained to plan the audit. The form and extent of this documentation is influenced by the ~~size and~~

~~complexity of the entity, as well as the~~ nature ***and complexity*** of the entity's ~~internal~~ control***s***. For example, documentation of the understanding of internal control of a ~~large~~ complex ***IT system*** ~~entity~~ ***in which a large volume of transactions are electronically initiated, recorded, processed, and reported*** may include flowcharts, questionnaires, or decision tables. For a ***system making limited or no use of IT or for which few transactions are processed (for example, long-term debt)*** ~~small entity, however~~, documentation in the form of a memorandum may be sufficient. Generally, the more complex internal control and the more extensive the procedures performed, the more extensive the auditor's documentation should be.

CONSIDERATION OF INTERNAL CONTROL IN ASSESSING CONTROL RISK

63. ~~45.~~ SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards,* vol. 1, AU sec. 326), states that most of the independent auditor's work in forming an opinion on financial statements consists of obtaining and evaluating evidential matter concerning the assertions in such financial statements. These assertions are embodied in the account balance, transaction class, and disclosure components of financial statements and are classified according to the following broad categories:

- Existence or occurrence
- Completeness
- Rights and obligations
- Valuation or allocation
- Presentation and disclosure

In planning and performing an audit, an auditor considers these assertions in the context of their relationship to a specific account balance or class of transactions.

64. ~~46.~~ The risk of material misstatement[***8***] [~~6~~] in financial statement assertions consists of inherent risk, control risk, and detection risk. Inherent risk is the susceptibility of an assertion to a material misstatement assuming there are no related controls. Control risk is the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the entity's internal control. Detection risk is the risk that the auditor will not detect a material misstatement that exists in an assertion.

65. ~~47.~~ Assessing control risk is the process of evaluating the effectiveness of an entity's internal control in preventing or detecting material misstatements in the financial statements. Control risk should be assessed in terms of financial statement assertions. After obtaining the understanding of internal control, the auditor may assess control risk at the maximum level for some or all assertions because he or she believes controls are unlikely to pertain to an assertion~~,~~ ***or*** are unlikely to be effective, or because evaluating the~~ir~~ effectiveness ***of controls*** would be inefficient.[***9***] [~~7~~] ***However, the auditor needs to be satisfied that performing substantive tests alone would be effective in restricting detection risk to***

[***8***] [~~6~~] For purposes of this Statement, a material misstatement in a financial statement assertion is a misstatement whether caused by error or fraud as discussed in SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards,* vol. 1, AU sec. 312), that either individually or when aggregated with other misstatements in other assertions would be material to the financial statements taken as a whole.

[***9***] [~~7~~] Control risk may be assessed in quantitative terms, such as percentages, or in nonquantitative terms that range, for example, from a maximum to a minimum. The term *maximum level* is used in this Statement to mean the greatest probability that a material misstatement that could occur in a financial statement assertion will not be prevented or detected on a timely basis by an entity's internal control.

an acceptable level. For example, the auditor may determine that performing substantive tests alone would be effective and more efficient than performing tests of controls for assertions related to fixed assets and to long-term debt in an entity where a limited number of transactions are related to those financial statement components, and when the auditor can readily obtain corroborating evidence in the form of documents and confirmations.

66. In other circumstances, the auditor may determine that performing tests of controls to assess control risk below the maximum for certain assertions would be effective and more efficient than performing only substantive tests. In addition, the auditor may determine that it is not practical or possible to restrict detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions. In such circumstances, the auditor should perform tests of controls to obtain evidential matter about the effectiveness of both the design and operation of controls to reduce the assessed level of control risk.[10]

67. In determining whether assessing control risk at the maximum level or at a lower level would be an effective approach for specific assertions, the auditor should consider factors that include—

- *The nature of the assertion.*
- *The volume of transactions or data related to the assertion.*
- *The nature and complexity of the systems, including the use of IT, by which the entity processes and controls information supporting the assertion.*
- *The nature of the available evidential matter, including audit evidence that is available only in electronic form.*

68. In circumstances where a significant amount of information supporting one or more financial statement assertions is electronically initiated, recorded, processed, and reported, the auditor may need to perform tests of controls to determine whether internal controls are operating effectively and to support an assessment of control risk below the maximum. For such assertions, significant audit evidence may be available only in electronic form, in which case its competence usually depends on the effectiveness of internal controls over its validity and completeness. For example, the evidence, including related records, resulting from such functions performed by an entity's IT systems as executing credit checks or matching purchase orders with shipping documents may be maintained only in electronic format.

69. Furthermore, the potential for improper alteration of information to occur and not be detected may be greater if information is initiated, recorded, processed, and reported only in electronic form and appropriate controls are not operating effectively. In such circumstances, the auditor may find it impossible to design effective substantive tests that by themselves would provide sufficient evidence that the assertions are not materially misstated as a result of improper initiation, suppression, or alteration of information. Evidential matter obtained from tests of controls may be required to enable the auditor to audit the related financial statement assertions.

70. Examples of situations where the auditor may determine that he or she should perform tests of controls to gather evidential matter to use in assessing control risk include the following:

- *An entity that conducts business using a system in which the computer initiates orders for goods based on predetermined rules and pays the related payables based on electronic*

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[10] *If the auditor is unable to obtain such evidential matter, he or she should consider the guidance in SAS No. 31 (AU 326.14 and 326.25).*

information in transactions regarding receipt of goods. No other documentation of orders or goods received is produced or maintained.

- ***An entity that provides electronic services to customers (for example, an Internet service provider or a telephone company) and uses computer applications to log services provided to users, initiate bills for the services, process the billing transactions, and automatically record such amounts in electronic accounting records that are used to produce the financial statements.***

In such cases, it may not be possible for the auditor to design effective tests without obtaining evidence about the operating effectiveness of the automated controls.

71.~~48.~~ Assessing control risk at below the maximum level involves[11]—

- Identifying specific controls relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions.

- Performing tests of controls to evaluate the effectiveness of such controls.

- ***Concluding on the assessed level of control risk.***

- ***Documenting the assessed level of control risk.***

Identifying Controls

72.~~49.~~ ***The knowledge that an auditor gains from obtaining an understanding about internal control should be used to identify the types of potential misstatement that could occur in financial statement assertions, and to consider factors that affect the risk of material misstatement. In assessing control risk, the auditor should identify the controls that are likely to prevent or detect material misstatement in specific assertions.*** In identifying controls relevant to specific financial statement assertions, the auditor should consider that the controls can have either a pervasive effect on many assertions or a specific effect on an individual assertion, depending on the nature of the particular internal control component involved. For example, the conclusion that an entity's control environment is highly effective may influence the auditor's decision about the number of an entity's locations at which auditing procedures are to be performed or whether to perform certain auditing procedures for some account balances or transaction classes at an interim date. Either decision affects the way in which auditing procedures are applied to specific assertions, even though the auditor may not have specifically considered each individual assertion that is affected by such decisions.

73.~~50.~~ Conversely, some control activities often have a specific effect on an individual assertion embodied in a particular account balance or transaction class. For example, the control activities that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the existence assertion for the inventory account balance.

74.~~51.~~ Controls can be either directly or indirectly related to an assertion. The more indirect the relationship, the less effective that control may be in reducing control risk for that assertion. For example, a sales manager's review of a summary of sales activity for specific stores by region ordinarily is indirectly related to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing

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[11] ***SAS No. 70 describes reports that an auditor may obtain that may assist in identifying controls relevant to specific assertions and obtaining evidential matter regarding their operating effectiveness when an entity uses a service organization.***

control risk for that assertion than controls more directly related to that assertion, such as matching shipping documents with billing documents.

75. Certain IT application controls may relate directly to one or more assertions, but their continued effective operation usually depends on general controls that are indirectly related to the assertions. Such indirect general controls usually include program change controls and access controls that restrict access to programs and related data. The auditor should consider the need to identify not only IT application controls directly related to the assertions, but also other indirect general controls on which they depend.

Performing Tests of Controls

76.~~52.~~ Procedures ***to obtain evidential matter about*** ~~directed toward either~~ the effectiveness of the design or operation of a control are referred to as tests of controls ***(paragraphs 91 through 105 of this section discuss characteristics of evidential matter to consider when performing tests of controls)***. Tests of controls directed toward the effectiveness of the design of a control are concerned with whether that control is suitably designed to prevent or detect material misstatements in specific financial statement assertions. Tests to obtain such evidential matter ordinarily include procedures such as inquiries of appropriate entity personnel, inspection of documents and reports, and observation of the application of specific controls. For entities with complex internal control, the auditor should consider that the use of flowcharts, questionnaires, or decision tables might facilitate the application of tests of design.

77.~~53.~~ Tests of controls directed toward the operating effectiveness of a control are concerned with how the control was applied, the consistency with which it was applied during the audit period, and by whom it was applied ***or monitored***. These tests ordinarily include procedures such as inquiries of appropriate entity personnel; inspection of documents, reports, or electronic files, indicating performance of the control; observation of the application of the control; and reperformance of the application of the control by the auditor. In some circumstances, a specific procedure may address the effectiveness of both design and operation. However, a combination of procedures may be necessary to evaluate the effectiveness of the design or operation of a control.

78. In designing tests of automated controls, the auditor should consider the need to obtain evidence supporting the effective operation of controls directly related to the assertions as well as other indirect controls on which these controls depend. For example, the auditor may identify a "user review of an exception report of credit sales over a customer's authorized credit limit" as a direct control related to an assertion. In such cases, the auditor should consider the effectiveness of the user review of the report and also the controls related to the accuracy of the information in the report (for example, the indirect IT controls).

79. Because of the inherent consistency of IT processing, the auditor may be able to reduce the extent of testing of an automated control since the computer will perform the control in the same way each time unless the program is changed. Once the auditor determines that automated controls are functioning as intended (which could be done at the time the control is initially implemented or at some other date), the auditor should consider performing tests to determine that such controls continue to function effectively. Such tests might include determining that changes to the program are not made without being subject to the appropriate program change controls, and that the authorized version of the program is used for processing transactions.

80. To test automated controls, the auditor may need to use techniques that are different from those used to test manual controls. For example, computer-assisted audit techniques may be used to test automated controls or data related to assertions. Also, the auditor may use other automated tools or reports produced by the computer system to test the operating effectiveness of indirect controls, such as program change controls and access controls. The auditor should consider whether specialized skills are needed to design and perform such tests of controls.

Concluding on the Assessed Level of Control Risk

81. ~~54.~~ The conclusion reached as a result of assessing control risk is referred to as the assessed level of control risk. In determining the evidential matter necessary to support a specific assessed level of control risk at below the maximum level, the auditor should consider the characteristics of evidential matter about control risk discussed in paragraphs ***91*** ~~64~~ through ***105*** ~~78~~. Generally, however, the lower the assessed level of control risk, the greater the assurance the evidential matter must provide that the controls relevant to an assertion are designed and operating effectively.

82. ~~55.~~ The auditor uses the assessed level of control risk (together with the assessed level of inherent risk) to determine the acceptable level of detection risk for financial statement assertions. The auditor uses the acceptable level of detection risk to determine the nature, timing, and extent of the auditing procedures to be ***applied to the account balance or class of transactions*** ~~used~~ to detect material misstatements in the financial statement assertions. Auditing procedures designed to detect such misstatements are referred to in this Statement as substantive tests.

83. ~~56.~~ As the acceptable level of detection risk decreases, the assurance provided from substantive tests should increase. Consequently, the auditor may do one or more of the following:

- Change the nature of substantive tests from a less effective to a more effective procedure, such as using tests directed toward independent parties outside the entity rather than tests directed toward parties or documentation within the entity.

- Change the timing of substantive tests, such as performing them at year end rather than at an interim date.

- Change the extent of substantive tests, such as using a larger sample size.

Document*ing* ~~ation of~~ the Assessed Level of Control Risk

84. ~~57.~~ In addition to the documentation of the understanding of internal control discussed in paragraph ***62*** ~~44~~, the auditor should document the basis for his or her conclusions about the assessed level of control risk. Conclusions about the assessed level of control risk may differ as they relate to various account balances or classes of transactions. However, for those financial statement assertions where control risk is assessed at the maximum level, the auditor should document his or her conclusion that control risk is at the maximum level but need not document the basis for that conclusion. For those assertions where the assessed level of control risk is below the maximum level, the auditor should document the basis for his or her conclusion that the effectiveness of the design and operation of controls supports that assessed level. The nature and extent of the auditor's documentation are influenced by the assessed level of control risk used, the nature of the entity's internal control, and the nature of the entity's documentation of internal control.

RELATIONSHIP OF UNDERSTANDING TO ASSESSING CONTROL RISK

85. ~~58.~~ Although understanding internal control and assessing control risk are discussed separately in this Statement, they may be performed concurrently in an audit. The objective of procedures performed to obtain an understanding of internal control (discussed in paragraphs ***59*** ~~41~~ through ***61*** ~~43~~) is to provide the auditor with knowledge necessary for audit planning. The objective of tests of controls (discussed in paragraphs ***76*** ~~52~~ ***through*** ~~and~~ ***80*** ~~53~~) is to provide the auditor with evidential matter to use in assessing control risk. However, procedures performed to achieve one objective may also pertain to the other objective.

86. ~~59.~~ Based on the assessed level of control risk the auditor expects to support and audit efficiency considerations, the auditor often plans to perform some tests of controls concurrently with obtaining the

understanding of internal control. In addition, even though some of the procedures performed to obtain the understanding may not have been specifically planned as tests of controls, they may also provide evidential matter about the effectiveness of both the design and operation of the controls relevant to certain assertions and, consequently, serve as tests of controls. ***For example, because of the inherent consistency of IT processing, performing procedures to determine whether an automated control has been placed in operation may serve as a test of that control's operating effectiveness, depending on such factors as whether the program has been changed or whether there is a significant risk of unauthorized change or other improper intervention. Also,*** ~~For example,~~ in obtaining an understanding of the control environment, the auditor may have made inquiries about management's use of budgets, observed management's comparison of monthly budgeted and actual expenses, and inspected reports pertaining to the investigation of variances between budgeted and actual amounts. Although these procedures provide knowledge about the design of the entity's budgeting policies and whether they have been placed in operation, they may also provide evidential matter about the effectiveness of the design and operation of budgeting policies in preventing or detecting material misstatements in the classification of expenses. In some circumstances, that evidential matter may be sufficient to support an assessed level of control risk that is below the maximum level for the presentation and disclosure assertions pertaining to expenses in the income statement.

87.~~60.~~ When the auditor concludes that procedures performed to obtain the understanding of internal control also provide evidential matter for assessing control risk, he or she should consider the guidance in paragraphs ***91*** ~~64~~ through ***105*** ~~78~~ in judging the degree of assurance provided by that evidential matter. Although such evidential matter may not provide sufficient assurance to support an assessed level of control risk that is below the maximum level for certain assertions, it may do so for other assertions and thus provide a basis for modifying the nature, timing, or extent of the substantive tests that the auditor plans for those assertions. However, such procedures are not sufficient to support an assessed level of control risk below the maximum level if they do not provide sufficient evidential matter to evaluate the effectiveness of both the design and operation of a control relevant to an assertion.

Further Reduction in the Assessed Level of Control Risk

88.~~61.~~ After obtaining the understanding of internal control and assessing control risk, the auditor may desire to seek a further reduction in the assessed level of control risk for certain assertions. In such cases, the auditor considers whether additional evidential matter sufficient to support a further reduction is likely to be available, and whether it would be efficient to perform tests of controls to obtain that evidential matter. The results of the procedures performed to obtain the understanding of the internal control, as well as pertinent information from other sources, help the auditor to evaluate those two factors.

89.~~62.~~ In considering efficiency, the auditor recognizes that additional evidential matter that supports a further reduction in the assessed level of control risk for an assertion would result in less audit effort for the substantive tests of that assertion. The auditor weighs the increase in audit effort associated with the additional tests of controls that is necessary to obtain such evidential matter against the resulting decrease in audit effort associated with the reduced substantive tests. When the auditor concludes it is inefficient to obtain additional evidential matter for specific assertions, the auditor uses the assessed level of control risk based on the understanding of internal control in planning the substantive tests for those assertions.

90.~~63.~~ For those assertions for which the auditor performs additional tests of controls, the auditor determines the assessed level of control risk that the results of those tests will support. This assessed level of control risk is used in determining the appropriate detection risk to accept for those assertions and, accordingly, in determining the nature, timing, and extent of substantive tests for such assertions.

EVIDENTIAL MATTER TO SUPPORT THE ASSESSED LEVEL OF CONTROL RISK

91.~~64.~~ When the auditor assesses control risk at below the maximum level, he or she should obtain sufficient evidential matter to support that assessed level. The evidential matter[12 8] that is sufficient to support a specific assessed level of control risk is a matter of auditing judgment. Evidential matter varies substantially in the assurance it provides to the auditor as he or she develops an assessed level of control risk. The type of evidential matter, its source, its timeliness, and the existence of other evidential matter related to the conclusion to which it leads all bear on the degree of assurance evidential matter provides.

92.~~65.~~ These characteristics influence the nature, timing, and extent of the tests of controls that the auditor applies to obtain evidential matter about control risk. The auditor selects such tests from a variety of techniques such as inquiry, observation, inspection, and reperformance of a control that pertains to an assertion. No one specific test of controls is always necessary, applicable, or equally effective in every circumstance.

Type of Evidential Matter

93.~~66.~~ The nature of the particular controls that pertain to an assertion influences the type of evidential matter that is available to evaluate the effectiveness of the design or operation of those controls. For some controls, documentation of design or operation may exist. In such circumstances, the auditor may decide to inspect the documentation to obtain evidential matter about the effectiveness of design or operation.

94.~~67.~~ For other controls, however, such documentation may not be available or relevant. For example, documentation of design or operation may not exist for some factors in the control environment, such as assignment of authority and responsibility, or for some types of control activities, such as segregation of duties or some control activities performed by a computer. In such circumstances, evidential matter about the effectiveness of design or operation may be obtained through observation or the use of computer-assisted audit techniques to reperform the application of relevant controls.

Source of Evidential Matter

95.~~68.~~ Generally, evidential matter about the effectiveness of the design and operation of controls obtained directly by the auditor, such as through observation, provides more assurance than evidential matter obtained indirectly or by inference, such as through inquiry. For example, evidential matter about the proper segregation of duties that is obtained by the auditor's direct personal observation of the individual who applies a control generally provides more assurance than making inquiries about the individual. The auditor should consider, however, that the observed application of a control might not be performed in the same manner when the auditor is not present.

96.~~69.~~ Inquiry alone generally will not provide sufficient evidential matter to support a conclusion about the effectiveness of design or operation of a specific control. When the auditor determines that a specific control may have a significant effect in reducing control risk to a low level for a specific assertion, he or she ordinarily needs to perform additional tests to obtain sufficient evidential matter to support the conclusion about the effectiveness of the design or operation of that control.

Timeliness of Evidential Matter

97.~~70.~~ The timeliness of the evidential matter concerns when it was obtained and the portion of the audit period to which it applies. In evaluating the degree of assurance that is provided by evidential matter, the auditor should consider that the evidential matter obtained by some tests of controls, such as observation, pertains only to the point in time at which the auditing procedure was applied. Consequently, such

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[12 8] See also SAS No. 31 for guidance on evidential matter.

evidential matter may be insufficient to evaluate the effectiveness of the design or operation of controls for periods not subjected to such tests. In such circumstances, the auditor may decide to supplement these tests with other tests of controls that are capable of providing evidential matter about the entire audit period. For example, for a control ~~activity~~ performed by a computer program, the auditor may test the operation of the control at a particular point in time to obtain evidential matter about whether ~~the program executes~~ the control ***is operating*** effectively ***at that point in time***. The auditor may then perform tests of controls directed toward the design and operation of other control activities pertaining to the modification and the use of that computer program during the audit period to obtain evidential matter about whether the ~~programmed~~ control ~~activity~~ operated consistently during the audit period.

98.~~71.~~ Evidential matter about the effective design or operation of controls that was obtained in prior audits may be considered by the auditor in assessing control risk in the current audit. To evaluate the use of such evidential matter for the current audit, the auditor should consider the significance of the assertion involved, the specific controls that were evaluated during the prior audits, the degree to which the effective design and operation of those controls were evaluated, the results of the tests of controls used to make those evaluations, and the evidential matter about design or operation that may result from substantive tests performed in the current audit. The auditor should also consider that the longer the time elapsed since the performance of tests of controls to obtain evidential matter about control risk, the less assurance it may provide.

99.~~72.~~ When considering evidential matter obtained from prior audits, the auditor should obtain evidential matter in the current period about whether changes have occurred in internal control, including its policies, procedures, and personnel, subsequent to the prior audits, as well as the nature and extent of any such changes. ***For example, in performing the prior audit, the auditor may have determined that an automated control was functioning as intended. The auditor should test program change controls or obtain other evidence to determine whether changes to the automated control have been made that would affect its continued effective functioning.*** Consideration of evidential matter about these changes, together with the considerations in the preceding paragraph, may support either increasing or decreasing the additional evidential matter about the effectiveness of design and operation to be obtained in the current period.

100.~~73.~~ When the auditor obtains evidential matter about the design or operation of controls during an interim period, he or she should determine what additional evidential matter should be obtained for the remaining period. In making that determination, the auditor should consider the significance of the assertion involved, the specific controls that were evaluated during the interim period, the degree to which the effective design and operation of those controls were evaluated, the results of the tests of controls used to make that evaluation, the length of the remaining period, and the evidential matter about design or operation that may result from the substantive test performed in the remaining period. The auditor should obtain evidential matter about the nature and extent of any significant changes in internal control, including its policies, procedures, and personnel, that occur subsequent to the interim period.

Interrelationship of Evidential Matter

101.~~74.~~ The auditor should consider the combined effect of various types of evidential matter relating to the same assertion in evaluating the degree of assurance that evidential matter provides. In some circumstances, a single type of evidential matter may not be sufficient to evaluate the effective design or operation of a control. To obtain sufficient evidential matter in such circumstances, the auditor may perform other tests of controls pertaining to that control. For example, an auditor may observe ***the procedures for opening the mail and processing cash receipts to evaluate the operating effectiveness of controls over cash receipts***~~that programmers are not authorized to operate the computer~~. Because an observation is pertinent only at the point in time at which it is made, the auditor may supplement the observation with inquiries ***of entity personnel and inspection of documentation about the operation of such controls at other times***~~about the frequency and circumstances under which programmers may have access to the computer and may inspect documentation of past instances~~

~~when programmers attempted to operate the computer to determine how such attempts were prevented or detected~~.

102.~~75.~~ In addition, when evaluating the degree of assurance provided by evidential matter, the auditor should consider the interrelationship of an entity's control environment, risk assessment, control activities, information and communication, and monitoring. Although an individual internal control component may affect the nature, timing, or extent of substantive tests for a specific financial statement assertion, the auditor should consider the evidential matter about an individual component in relation to the evidential matter about the other components in assessing control risk for a specific assertion.

103.~~76.~~ Generally, when various types of evidential matter support the same conclusion about the design or operation of a control, the degree of assurance provided increases. Conversely, if various types of evidential matter lead to different conclusions about the design or operation of a control, the assurance provided decreases. For example, based on the evidential matter that the control environment is effective, the auditor may have reduced the number of locations at which auditing procedures will be performed. If, however, when evaluating specific control activities, the auditor obtains evidential matter that such activities are ineffective, he or she may reevaluate his or her conclusion about the control environment and, among other things, decide to perform auditing procedures at additional locations.

104.~~77.~~ Similarly, evidential matter indicating that the control environment is ineffective may adversely affect an otherwise effective control for a particular assertion. For example, a control environment that is likely to permit unauthorized changes in a computer program may reduce the assurance provided by evidential matter obtained from evaluating the effectiveness of the program at a particular point in time. In such circumstances, the auditor may decide to obtain additional evidential matter about the design and operation of that program during the audit period. For example, the auditor might obtain and control a copy of the program and use computer-assisted audit techniques to compare that copy with the program that the entity uses to process data.

105.~~78.~~ An audit of financial statements is a cumulative process; as the auditor assesses control risk, the information obtained may cause him or her to modify the nature, timing, or extent of the other planned tests of controls for assessing control risk. In addition, information may come to the auditor's attention as a result of performing substantive tests or from other sources during the audit that differs significantly from the information on which his or her planned tests of controls for assessing control risk were based. For example, the extent of misstatements that the auditor detects by performing substantive tests may alter his or her judgment about the assessed level of control risk. In such circumstances, the auditor may need to reevaluate the planned substantive procedures, based on a revised consideration of the assessed level of control risk for all or some of the financial statement assertions.

CORRELATION OF CONTROL RISK WITH DETECTION RISK

106.~~79.~~ The ultimate purpose of assessing control risk is to contribute to the auditor's evaluation of the risk that material misstatements exist in the financial statements. The process of assessing control risk (together with assessing inherent risk) provides evidential matter about the risk that such misstatements may exist in the financial statements. The auditor uses this evidential matter as part of the reasonable basis for an opinion referred to in the third standard of field work, which follows:

> Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

107.~~80.~~ After considering the level to which he or she seeks to restrict the risk of a material misstatement in the financial statements and the assessed levels of inherent risk and control risk, the auditor performs substantive tests to restrict detection risk to an acceptable level. As the assessed level of control risk

decreases, the acceptable level of detection risk increases. Accordingly, the auditor may alter the nature, timing, and extent of the substantive tests performed.

108. ~~81.~~ Although the inverse relationship between control risk and detection risk may permit the auditor to change the nature or the timing of substantive tests or limit their extent, ordinarily the assessed level of control risk cannot be sufficiently low to eliminate the need to perform any substantive tests to restrict detection risk for all of the assertions relevant to significant account balances or transaction classes. Consequently, regardless of the assessed level of control risk, the auditor should perform substantive tests for significant account balances and transaction classes.

109. ~~82.~~ The substantive tests that the auditor performs consist of tests of details of transactions and balances, and analytical procedures. In assessing control risk, the auditor also may use tests of details of transactions as tests of controls. The objective of tests of details of transactions performed as substantive tests is to detect material misstatements in the financial statements. The objective of tests of details of transactions performed as tests of controls is to evaluate whether a control operated effectively. Although these objectives are different, both may be accomplished concurrently through performance of a test of details on the same transaction. The auditor should recognize, however, that careful consideration should be given to the design and evaluation of such tests to ensure that both objectives will be accomplished.

EFFECTIVE DATE

~~***110.*** 83. This section is effective for audits of financial statements for periods beginning on or after January 1, 1990. Paragraphs 1 to 40 and the appendix [paragraph 84] are effective for audits of financial statements for periods beginning on or after January 1, 1997. Early application of the provisions of this section is permissible.~~ ***The amendments to this Statement are effective for audits of financial statements for periods beginning on or after June 1, 2001. Earlier application is permissible.***

~~***111.*** 84.~~

APPENDIX

INTERNAL CONTROL COMPONENTS

1. This appendix discusses the five internal control components set forth in paragraph ***8*** ~~7~~ and briefly described in paragraphs ***35*** ~~25~~ through ***58*** ~~40~~ as they relate to a financial statement audit.

CONTROL ENVIRONMENT

2. The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.

3. The control environment encompasses the following factors:

   a. *Integrity and ethical values.* The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical values are essential elements of the control environment, affecting the design, administration, and monitoring of other components. Integrity and ethical behavior are the product of the entity's ethical and behavioral standards, how they are communicated, and how they are reinforced in practice. They include management's actions to remove or reduce incentives and temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. They also include the communication of entity values and

behavioral standards to personnel through policy statements and codes of conduct and by example.

b. *Commitment to competence.* Competence is the knowledge and skills necessary to accomplish tasks that define the individual's job. Commitment to competence includes management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

c. *Board of directors or audit committee participation.* An entity's control consciousness is influenced significantly by the entity's board of directors or audit committee. Attributes include the board or audit committee's independence from management, the experience and stature of its members, the extent of its involvement and scrutiny of activities, the appropriateness of its actions, the degree to which difficult questions are raised and pursued with management, and its interaction with internal and external auditors.

d. *Management's philosophy and operating style.* Management's philosophy and operating style encompass a broad range of characteristics. Such characteristics may include the following: management's approach to taking and monitoring business risks; management's attitudes and actions toward financial reporting (conservative or aggressive selection from available alternative accounting principles, and conscientiousness and conservatism with which accounting estimates are developed); and management's attitudes toward information processing and accounting functions and personnel.

e. *Organizational structure.* An entity's organizational structure provides the framework within which its activities for achieving entity-wide objectives are planned, executed, controlled, and monitored. Establishing a relevant organizational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. An entity develops an organizational structure suited to its needs. The appropriateness of an entity's organizational structure depends, in part, on its size and the nature of its activities.

f. *Assignment of authority and responsibility.* This factor includes how authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established. It also includes policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, it includes policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognize how and for what they will be held accountable.

g. *Human resource policies and practices.* Human resource policies and practices relate to hiring, orientation, training, evaluating, counseling, promoting, compensating, and remedial actions. For example, standards for hiring the most qualified individuals—with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior—demonstrate an entity's commitment to competent and trustworthy people. Training policies that communicate prospective roles and responsibilities and include practices such as training schools and seminars illustrate expected

levels of performance and behavior. Promotions driven by periodic performance appraisals demonstrate the entity's commitment to the advancement of qualified personnel to higher levels of responsibility.

Application to Small and Midsized Entities

4. Small and midsized entities may implement the control environment factors differently than larger entities. For example, smaller entities might not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Similarly, smaller entities may not have an independent or outside member on their board of directors. However, these conditions may not affect the auditor's assessment of control risk.

RISK ASSESSMENT

5. An entity's risk assessment for financial reporting purposes is its identification, analysis, and management of risks relevant to the preparation of financial statements that are fairly presented in conformity with generally accepted accounting principles. For example, risk assessment may address how the entity considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements. Risks relevant to reliable financial reporting also relate to specific events or transactions.

6. Risks relevant to financial reporting include external and internal events and circumstances that may occur and adversely affect an entity's ability to ***initiate***, record, process, ~~summarize,~~ and report financial data consistent with the assertions of management in the financial statements. Once risks are identified, management considers their significance, the likelihood of their occurrence, and how they should be managed. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations. Risks can arise or change due to circumstances such as the following:

- *Changes in operating environment.* Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.

- *New personnel.* New personnel may have a different focus on or understanding of internal control.

- *New or revamped information systems.* Significant and rapid changes in information systems can change the risk relating to internal control.

- *Rapid growth.* Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.

- *New technology.* Incorporating new technologies into production processes or information systems may change the risk associated with internal control.

- *New* ***business models,*** *~~lines,~~ products, or activities.* Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.

- *Corporate restructurings.* Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.

- ***Expanded f****~~F~~oreign operations.* The expansion or acquisition of foreign operations carries new and often unique risks that may ~~impact~~ ***affect*** internal control, for example, additional or changed risks from foreign currency transactions.

- ***New a****Accounting pronouncements*. Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

Application to Small and Midsized Entities

7. The basic concepts of the risk assessment process should be present in every entity, regardless of size, but the risk assessment process is likely to be less formal and less structured in small and midsized entities than in larger ones. All entities should have established financial reporting objectives, but they may be recognized implicitly rather than explicitly in smaller entities. Management may be able to learn about risks related to these objectives through direct personal involvement with employees and outside parties.

CONTROL ACTIVITIES

8. Control activities are the policies and procedures that help ensure that necessary actions are taken to address risks to achievement of the entity's objectives. Control activities***, whether automated or manual,*** have various objectives and are applied at various organizational and functional levels.

9. Generally, control activities that may be relevant to an audit may be categorized as policies and procedures that pertain to the following:

- *Performance reviews*. These control activities include reviews of actual performance versus budgets, forecasts, and prior period performance; relating different sets of data—operating or financial—to one another, together with analyses of the relationships and investigative and corrective actions; and review of functional or activity performance, such as a bank's consumer loan manager's review of reports by branch, region, and loan type for loan approvals and collections.

- *Information processing*. A variety of controls are performed to check accuracy, completeness, and authorization of transactions. The two broad groupings of information systems control activities are general controls and application controls. General controls commonly include controls over data center ***and network*** operations, system software acquisition and maintenance, access security, and application system development and maintenance. These controls apply to mainframe, minicomputer, and end-user environments. Application controls apply to the processing of individual applications. These controls help ensure that transactions are valid, properly authorized, and completely and accurately ***recorded and*** processed.

- *Physical controls*. These activities encompass the physical security of assets, including adequate safeguards such as secured facilities, over access to assets and records; authorization for access to computer programs and data files; and periodic counting and comparison with amounts shown on control records. The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation, and therefore the audit, depends on the circumstances such as when assets are highly susceptible to misappropriation. For example, these controls would ordinarily not be relevant when any inventory losses would be detected pursuant to periodic physical inspection and recorded in the financial statements. However, if for financial reporting purposes management relies solely on perpetual inventory records, the physical security controls would be relevant to the audit.

- *Segregation of duties*. Assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or irregularities in the normal course of his or her duties.

Application to Small and Midsized Entities

10. The concepts underlying control activities in small or midsized organizations are likely to be similar to those in larger entities, but the formality with which they operate varies. Further, smaller entities may find that certain types of control activities are not relevant because of controls applied by management. For example, management's retention of authority for approving credit sales, significant purchases, and draw-downs on lines of credit can provide strong control over those activities, lessening or removing the need for more detailed control activities. An appropriate segregation of duties often appears to present difficulties in smaller organizations. Even companies that have only a few employees, however, may be able to assign their responsibilities to achieve appropriate segregation or, if that is not possible, to use management oversight of the incompatible activities to achieve control objectives.

INFORMATION AND COMMUNICATION

11. An information system consists of infrastructure (physical and hardware components), software, people, procedures (manual and automated), and data. Infrastructure and software will be absent, or have less significance, in systems that are exclusively or primarily manual.

12.~~11~~. The information system relevant to financial reporting objectives, which includes the accounting system, consists of the ***procedures***~~methods~~***, whether automated or manual,*** and records established to ***initiate,*** record, process, ~~summarize,~~ and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity. ***Transactions may be initiated manually or automatically by programmed procedures. Recording includes identifying and capturing the relevant information for transactions or events. Processing includes functions such as edit and validation, calculation, measurement, valuation, summarization, and reconciliation, whether performed by automated or manual procedures. Reporting relates to the preparation of financial reports as well as other information, in electronic or printed format, that the entity uses in monitoring and other functions.*** The quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports.

13~~12~~. ***Accordingly, a***~~A~~n information system encompasses methods and records that—

- Identify and record all valid transactions.
- Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
- Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
- Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
- Present properly the transactions and related disclosures in the financial statements.

14~~13~~. Communication involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. It includes the extent to which personnel understand how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Open communication channels help ensure that exceptions are reported and acted on.

15~~14~~. Communication takes such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made orally and through the actions of management.

Application to Small and Midsized Entities

16~~15~~. Information systems in small or midsized organizations are likely to be less formal than in larger organizations, but their role is just as significant. Smaller entities with active management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Communication may be less formal and easier to achieve in a small or midsized company than in a larger enterprise due to the smaller organization's size and fewer levels as well as management's greater visibility and availability.

MONITORING

17~~16~~. Monitoring is a process that assesses the quality of internal control performance over time. It involves assessing the design and operation of controls on a timely basis and taking necessary corrective actions. This process is accomplished through ongoing monitoring activities, separate evaluations, or a combination of the two.

18~~17~~. Ongoing monitoring activities are built into the normal recurring activities of an entity and include regular management and supervisory activities. Managers of sales, purchasing, and production at divisional and corporate levels are in touch with operations and may question reports that differ significantly from their knowledge of operations.

19~~18~~. In many entities, internal auditors or personnel performing similar functions contribute to the monitoring of an entity's activities through separate evaluations. They regularly provide information about the functioning of internal control, focusing considerable attention on evaluating the design and operation of internal control. They communicate information about strengths and weaknesses and recommendations for improving internal control.

20~~19~~. Monitoring activities may include using information from communications from external parties. Customers implicitly corroborate billing data by paying their invoices or complaining about their charges. In addition, regulators may communicate with the entity concerning matters that affect the functioning of internal control, for example, communications concerning examinations by bank regulatory agencies. Also, management may consider communications relating to internal control from external auditors in performing monitoring activities.

Application to Small and Midsized Entities

21~~20~~. Ongoing monitoring activities of small and midsized entities are more likely to be informal and are typically performed as a part of the overall management of the entity's operations. Management's close involvement in operations often will identify significant variances from expectations and inaccuracies in financial data.